CHAPTER 7

401k determination issues

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INTERNAL REVENUE SERVICE
TAX EXEMPT AND GOVERNMENT ENTITIES

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Introduction

Statutory background

The Small Business Job Protection Act of 1996 (SBJPA), P.L. 104-188, added new Internal Revenue Code sections 401(k)(12) and 401(m)(11), effective for plan years beginning after December 31, 1998.

This enactment was in response to lobbying from the pension community, who wanted relief from the ADP and ACP tests that were required to show a plan operated in a nondiscriminatory manner. The ADP and ACP tests are required under Internal Revenue Code sections 401(k) and 401(m), respectively.

ADP and ACP tests no longer required if plan uses safe harbor

With the addition of IRC sections 401(k)(12) and 410(m)(11), the ADP and ACP tests may no longer be required if a plan meets the ADP Test Safe Harbor and (if applicable) the ACP Test Safe Harbor.

- Internal Revenue Code section 401(k)(12) provides that (for plan years beginning on or after January 01, 1999), a cash or deferred arrangement ("CODA") which meets the safe harbor requirements is deemed to satisfy the ADP test.

- Internal Revenue Code section 401(m)(11) provides that (for plan years beginning on or after January 01, 1999), a CODA which meets the safe harbor requirements (and additional requirements of Internal Revenue Code section 401(m)(11)(B)) is deemed to satisfy the ACP test.

Chapter organization

The chapter provides a synopsis of the ADP test safe harbor and the ACP test safe harbor requirements. Further detail on safe harbor 401(k) plans may be found at the following cites:

1. Employee Plans CPE Topics for 2002.
2. Notice 98-52
3. Notice 2000-3
4. Document 7335, Explanation No. 12, Section 401(k) Requirements
5. Document 7334, Explanation No. 11, Employee and Matching Contributions

ADP Safe Harbor contributions

Introduction

The employer must contribute either:

- matching contributions or
- nonelective contributions.

Matching Contributions

Matching contributions

Matching contribution test is satisfied if the plan provides for either a. or b.

Basic formula: 100% of the first 3% deferred, plus 50% of the next 2% deferred.

Enhanced formula: *no less* than what the basic formula would be at *each* deferral rate.

Other requirements for matching contribution

The rate of match can't increase as the rate of deferral increases.

No HCE can receive a greater match than any NHCE who defers at the same rate.

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Matching Contributions, Continued

Example 1- illustrating match

A plan provides that matching contributions will be made at the following rates:

- 100 percent of an employee's elective contributions that do not exceed **2** percent of compensation and
- 75 percent of the employee's elective contributions that exceed 2 percent but do not exceed 5 percent of compensation.

This formula **does not** satisfy the enhanced matching formula since the aggregate amount that is provided by this formula is not at least equal to the amount that would have been provided under the basic matching formula at *all* rates of elective contributions.

- Under the basic matching formula, matching contributions of 100 percent would be made on the amount of the employee's elective contributions that do not exceed 3 percent of compensation.
- Under the plan's formula, the amount of matching contributions at 3 percent is less than 100 percent.

For additional examples, see the examples in section V.B.3. of Notice 98-52..

Example 2— illustrating matching contributions

A 401(k) plan provides a matching contribution equal to 100% of the first 4% deferred. The matching contribution is 100% vested. The ADP Safe Harbor is satisfied based on the enhanced formula.

Nonelective contributions

Nonelective contributions

Nonelective contribution: no less than 3% of compensation..

Other Issues

ADP safe harbor may not be discretionary

The safe harbor ADP contribution may **not** be discretionary.

- The required notice to employees (see 8.) may provide that the final decision to make the safe harbor nonelective contribution will be made at least 30 days (and no more than 90 days) before the last day of the plan year.
- The plan sponsor cannot "default" to normal ADP/ACP testing without amending the plan.

Section XI of Notice 98-52 provides that a safe harbor 401(k) plan must contain language stating that it is a safe harbor 401(k) plan. See IRS memorandum dated July 12, 2002, which has been included at the end of this chapter.

Plan requirements—Eligibility and participation

1. A safe harbor contribution must be provided to all NHCEs that are eligible for the 401(k).

2. The LRM for safe harbor 401(k) plans describe an eligible employee as an employee who is:

   - Who is eligible to make elective deferrals under the plan for any part of the plan year or

   - who would be eligible to make elective deferrals but for a suspension due to a hardship distribution

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Other Issues, Continued

Plan requirements—Eligibility and participation (continued)

3. The plan may not require a minimum number of hours be worked during the plan year, or employment on the last day of the plan year, to accrue the safe harbor contribution

The safe harbor contribution applies to NHCEs only; no HCE safe harbor contribution required.

Other issues

The safe harbor contribution may be provided in another defined contribution plan that has the same plan year. Review Section IX of Notice 98-52 for more information on this issue.

The ADP safe harbor nonelective contribution may not be taken into account for cross-tested plans imputing permitted disparity.

> The ADP safe harbor nonelective contribution can be taken into account under the gateway test in Treasury Reg. Section 1.401(a)(4)-8(b).

Result of satisfying the ADP safe harbor

1. The ADP test is not required if the criteria above are met.
2. A plan that meets the ADP test safe harbor requirements is not subject to the multiple use test.
3. IRC section 402(g) limits (see 16.) & 415(c) limits (see 22.) still apply.

This is also true for catch-up contributions.

ACP Safe harbor requirements

General requirements

The ACP test safe harbor is passed if:

- **any** of the three following requirements are met, and
- each NHCE eligible to receive a matching contribution is also eligible under the plan's ADP test safe harbor .

First requirement- plan satisfies the ADP safe harbor

ACP test deemed passed if the **basic matching formula** (see above) is met and the plan provides for **no** other matching contributions.

Second requirement- Plan satisfies ADP enhanced matching formula with certain conditions

ACP deemed passed if the enhanced matching formula (see above) is met, using elective deferrals (plus employee after-tax contributions, if applicable):

- that do not exceed 6% of the employee's compensation, and

  the plan provides for **no** other matching contributions.

Note: Though catch-up contributions are not subject to the ADP limit, any match allowed on catch-up contributions under IRC section 414(v) also is subject to the ACP test safe harbor requirements). Matches on catch-up contributions do not receive the same exempt treatment under 414(v) as do the catch-up contributions themselves.

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ACP Safe harbor requirements, Continued

Third requirement

In the case of any other plan that does not meet the first two requirements, the ACP test is deemed passed if:

- there *are* other matching contributions (matching contributions other than those meeting the basic matching formula or enhanced matching formula) and

- all the following apply under the plan:

    a. Matches are not made on elective deferrals (plus employee after-tax contributions, if applicable) that in the aggregate exceed 6% of compensation.
    b. The rate of match doesn't go up as the rate of elective deferrals (plus employee after-tax contributions, if applicable) goes up.
    c. No HCE can receive a greater rate of match than any NHCE.

The matching formula may be discretionary

A plan may also provide a matching formula that is discretionary. This matching formula can be provided by the plan in addition to the regular ADP or ACP safe harbor formula. This discretionary formula must meet the following requirements:

- The discretionary match can't exceed 4% of compensation. This limit does not apply to plan years beginning before 2000.
- Employer discretionary contributions may not be taken into account in determining whether the ADP test safe harbor is met.

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ACP Safe harbor requirements, Continued

Result of satisfying the ACP safe harbor

A. The ACP test is not required if 3. (above) is met.

B. The Basic Matching Formula (1.A.I.a. above) always satisfies the ACP test safe harbor.

C. The Enhanced Matching Formula (1.A.I.b. above) satisfies the ACP test safe harbor as long as deferrals on which there are matching contributions don't exceed 6% of compensation.

D. Employee after-tax contributions are subject to the ACP test, without exception.

Compensation, Vesting and withdrawal restrictions

Compensation used for ADP & ACP test safe harbor contributions

A. Compensation used must be in accordance with Treas. Reg. section 1.414(s)-1 (for example-415(c)(3) comp).

B. In determining matching contributions, compensation can be calculated on a plan year basis or a payroll period basis, e.g. bi-weekly, monthly or quarterly.

C. Compensation for the portion of the plan year that the employee isn't eligible to participate in the CODA may be ignored.

Vesting

The ADP test safe harbor matching and nonelective contributions (whichever applies) must be nonforfeitable.

Withdrawal restrictions

A. The ADP test safe harbor contributions (1. above) are subject to the 401(k) distribution restrictions. These contributions (and the earnings thereon) can't be distributable before the earlier of:
- Severance from employment,
- Death,
- Disability,
- Plan termination (pursuant to IRC section 401(k)(10)), or
- Age 59 ½ (for a profit sharing or stock bonus plan).

B. The safe harbor contributions (and the earnings thereon) cannot be available for hardship withdrawal. IRC section 401(k)(2)(B)(i)(IV) is, thus, not applicable for this purpose.

Annual Notice

When notice is required and content

A. Notice is generally required 30-90 days prior to the first day of the plan year.

B. The content of the notice must be accurate, comprehensive and understandable.

C. A new plan may give its initial required annual notice up to the effective date of the plan (the date the employee becomes eligible).

D. An employee who becomes eligible after the end of the annual notice period must receive notice during the 90-day period ending on the day the employee becomes eligible.

E. March 1, 1999 extended notice deadline for a plan using the safe harbor provisions for the first time for the 1999 plan year.

F. May 1, 2000 extended notice deadline for a plan using the safe harbor provisions for the first time for the 2000 plan year.

G. Additional notice requirements can be found in Notice 98-52, Section C and Notice 2000-3, Q-7 through Q-11.

Plan year and Plan amendments

Defining plan year

A. In general, the plan year is 12 months long.

B. For a new plan (other than a successor plan) the new plan year may be less than 12 months long, but it must be at least 3 months long (except a newly established employer, establishing the plan as soon as administratively feasible after coming into existence, may use any shorter period).

C. Thus, if a short plan year occurs as the result of a plan amendment the safe harbor rules cannot be used for that short plan year.

D. The addition of a 401(k) feature to a non 401(k) plan of an established employer is treated as a new plan.

Plan amendments-when adopted and comply in operation

A. Conforming plan amendments must be adopted by the end of the GUST remedial amendment period.

B. The plan may comply in operation (if not in form) during the GUST remedial amendment period.

C. The GUST remedial can't be used as an excuse to retroactively adopt a 401(k) feature.

Eligibility and coverage requirements

Eligibility requirements

A. Same as a regular 401(k)

Coverage requirements

A. Same as a regular 401(k)

B. Under Notice 2000-3, Q&A-10, the plan that uses one of the 401(k) safe harbor methods is not required to provide safe harbor matching or nonelective contributions to participants who have not attained age 21 and performed one year of service.

Special rules for plans that benefit employees who have not met the age and

There are special rules with respect to a plan that benefits employees that are

- under age 21 and
- have less than one year of service (the age and service requirements under section 410(a)).

Under section 410(b)(4)(B) of the Code, an employer can apply the coverage rules separately to the portion of the plan that benefits only employees who benefit under the plan but who would not meet the age and service requirements under section 410.

For 401(k) purposes, the plan may be treated as two separate plans and the ADP safe harbor test **need only be satisfied by one of the plans**, as long as the employees not meeting the age and service requirements are also disaggregated for section 410(b) of the Code for coverage.

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Eligibility and coverage requirements, Continued

Safe harbor contributions may not have last day rule

The safe harbor contributions may not be limited to those employees who are:

- Still employed on the last day of the plan year or
- Worked more than a minimum number of hours during the plan year.

Contrast this requirement under Notice 98-52 with the requirements for a nonsafe harbor profit sharing plan (with or without a 401(k) feature), where the employer may exclude an employee who has worked less than 1,000 hours and is not employed on the last day of the plan year

Contributions

Other employer contributions

A. Other employer contributions are allowed in addition to safe harbor contributions.

B. The other employer contributions may be discretionary.

C. The safe harbor nonelective contributions may be taken into account in passing nondiscrimination testing under IRC section 401(a)(4), but may not be taken into account to satisfy permitted disparity rules under IRC section 401(l).

Employee after-tax contributions

A. Employee after-tax contributions are allowed.

B. Employee after-tax contributions are not eligible for the ACP test safe harbor, and thus subject to the ACP test .

C. A matching formula can apply to employee after-tax contributions and satisfy the ADP test safe harbor & the ACP test safe harbor, if either:

- the matching contributions provided on an employee's elective contributions are not affected by the amount of the employee's after-tax contributions, or

- matching contributions are made with respect to the sum of an employee's elective and after-tax contributions under the same terms as matching contributions are made with respect to elective contributions.

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Contributions, Continued

Top heavy minimum contributions

A. For plan years beginning in 2002, either a safe harbor matching contribution or the safe harbor nonelective contribution can be counted in satisfying the top heavy minimum contribution liability.

B. For plan years beginning prior to 2002, the only safe harbor contribution that could be counted in satisfying the top heavy minimum contribution liability was the safe harbor nonelective contribution.

C. In a regular (i.e. nonsafe harbor) IRC section 401(k) plan, the top heavy minimum is required only for nonkey employees still employed on the last day of the plan year. But the ADP test safe harbor contribution goes to all nonkey employees eligible, whether or not employed on the last day of the plan year.

D. A plan will not be considered top heavy if it meets the requirements of IRC sections 401(k)(12) (ADP test safe harbor) and 401(m)(11) (ACP test safe harbor).

Limits on elective deferrals and 415 limits

Limits on Elective deferrals

A. The employee calendar year section 402(g) limit applies, as under a regular 401(k) plan.

B. The plan may impose reasonable restrictions on NHCE elective deferrals.
- The plan may require whole dollar amounts or whole percentages for elective deferrals.
- Any plan-imposed restriction can't keep an employee from getting the maximum match available under the plan for the plan year.

C. Catch-up contributions are permitted, beginning with plan years starting in 2002. A plan will generally not violate any Code provision by allowing catch-up contributions.

IRC section 415 limits

A. The employee 415(c) annual addition limit (limitation year is the calendar year, unless another consecutive 12 month period is elected) applies, as with any other qualified plan.

Discontinuance (or reduction) of match

Discontinuance of match

A. This is allowed to occur during the plan year, but can't be effective any earlier than the later of (i) the date the amendment is adopted or (ii) 30 days after notice thereof is given to eligible employees.

B. After A. occurs, the plan must then go back to ADP and ACP testing for the plan year, using the current year testing method.

Disaggregation of excludable employees and permissive aggregation of plans

Disaggregation of excluable employees

A. Disaggregation on account of statutorily excludible employees is allowed.

B. This means safe harbor contributions may be provided only to statutory employees (i.e.-exclusion for age & service is permissible).

C. ADP (and, if applicable, ACP) testing is required for the employees excluded on account of disaggregation.

Permissive aggregation of plans

A. This is allowed, but the aggregate of plans must then satisfy the safe harbor rules.

Addition of a safe harbor plan

Addition of a safe harbor 401k safe harbor to an existing plan

A. Must be effective as of the beginning of a plan year.

Addition of a safe harbor to an existing non 401k plan

A. May be effective as late as the first day of the 10th month of the first safe harbor plan year.

B. A does not apply to a successor plan, which means that a successor plan defaults back to the rule noted at 20.A.

A successor plan is one where at least 50% of the eligible employees were eligible, in the prior year, for another 401(k) plan maintained by the employer.

Memo regarding default language in 401k plan

Internal Revenue Service

memorandum

date: 7/12/02

to: EP Employees

from: Richard Wickersham [*SIgned: R.W.*]
Manager, Technical Guidance and Quality Assurance; T:EP:RA:G

subject: Default Language in Safe Harbor 401(k) Plans

This memo clarifies that a plan intending to be a safe harbor 401(k) plan for a year may not contain "default" language whereby the ADP/ACP tests are performed in the event the plan fails to satisfy one or more of the requirements for a safe harbor 401(k) plan. The memo is in response to several reports from EP employees and others that the Service was not merely permitting but requiring such default language in safe harbor 401(k) plans.

The Small Business Job Protection Act added § 401(k)(12) and 401(m)(11) to the Code permitting, for plan years after 1998, a 401(k) plan to avoid performing the ADP/ACP tests provided the requirements of such Code sections were satisfied for the plan year. One of the requirements is that a notice be given to employees before each plan year stating that employees' elective contributions will be matched by the employer at a certain (stated) rate or that, in lieu of matching contributions, the employer will make a nonforfeitable contribution to all eligible employees equal to at least 3 percent of compensation (see § 401(k)(12)(D)). Guidance on safe harbor 401(k) plans can be found in Notice 98-52 and Notice 2000-3, and also in the IRM at 4.72.2.12.

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Memo regarding default language in 401k plan, Continued

Section XI of Notice 98-52 provides that a safe harbor 401(k) plan must contain language stating it is a safe harbor 401(k) plan. This is merely following the "definitely determinable" rule generally applicable to all qualified plans. Permitting so-called "default" language in a safe harbor 401(k) plan would undermine this rule and the notice requirement (described above), since the employer could "default" at will any year simply by not making the exact safe harbor contributions for the year.

Q&As -1 and -6 of Notice 2000-3 provide limited exceptions to the rule that a safe harbor 401(k) plan must be one for the entire plan year. In these instances, special notices must be provided prior to the plan year and when a change occurs, and the change must be accomplished by a plan amendment at that time.

If you have any questions on this memo, call or e-mail either myself or Roger Kuehnle.

401(k) - Selected Determination Issues

Overview

Introduction

Law changes in recent years (under GUST) have created a number of tricky areas in terms of plan language for 401(k) plans. This chapter will discuss several of those areas along with another common plan provision issue involving the top heavy minimum contribution in these plans. Reference Notices 97-2, 97-45 and 98-1

Objective

To review selected determination issues affecting 401(k) [401(m)] plans, understand the applicable law underlying each issue, and discuss ways that plan provisions can satisfy the requirements.

Definition of Highly Compensated Employee (HCE)

401k plan required to have HCE definition in plan

An IRC section 401(k) plan, unless it contains "SIMPLE" or "Safe Harbor CODA" provisions, is required to include the Actual Deferral Percentage (ADP) test (or incorporate it by reference) and state that it will be passed. Therefore, it is also required to define the terms that are used in applying the test.

One of the most significant of these terms (and one that is often defined inadequately in plans) is Highly Compensated Employee (HCE). The problem usually arises from the fact that the law allows for two options in how the plan defines this term, the top-paid group election and the calendar year election.

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Definition of Highly Compensated Employee (HCE), Continued

HCE statutory definition

Effective for plan years beginning after 12/31/1996, IRC section 414(q)(1) defines the term HCE as any employee who:

(A) was a 5-percent owner during the year or the preceding year, **or**

(B) for the preceding year:

i) had compensation from the employer in excess of $80,000, **and**

ii) if the employer elects the application of this clause for such preceding year, was in the top-paid group of employees for such preceding year.

Top paid and calendar year elections

Top paid group election-choice must be stated in the plan

The option that seems to cause the most trouble is called the "top-paid group election" which is referred to in IRC section 414(q)(1)(B)(ii) above. The key phrase in that subsection is at the beginning: "**if the employer elects**".

The most common mistake sponsors make is to simply copy the language of the code when defining HCE in their plans – including the "if the employer elects" phrase.

Of course, the plan language **must specify** the employer's choice when the law gives the employer options. A plan that provides the above language (from the Code) is leaving open the question of whether all employees with compensation in excess of $80,000 will be considered HCEs or only those in the top-paid group. Therefore, the definition is not definitely determinable and not acceptable in a qualified plan.

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Top paid and calendar year elections, Continued

The HCE language that must be included in the plan

In order to meet qualification standards, the plan definition of HCE must:

- not include the language from IRC section 414(q)(1)(B)(ii) – thereby not electing to consider the top-paid group in determining who is an HCE, or
- make a positive statement (was in the top-paid group… include and define the "top-paid group of employees" (in accordance with IRC section 414(q)(3)) as one of the criteria for being designated as an HCE ,or
- modify the IRC section 414(q)(1)(B)(ii) to read: "if the employer elects, **by plan amendment,** was…" – see IRS Memo dated 6/21/00 from the Manager, EP Determinations, Quality Assurance. This language is acceptable as it makes a negative, but definite statement regarding the election.

Calendar year election

Under the calendar year election an employer that maintains one or more plans on a fiscal year basis has the option calendar year data for the determination of whether an employee is an HCE.

Notice 97-45 defines the "determination year" (the applicable year for making the determination of who is an HCE) as the plan year. Therefore, the "preceding year" referred to in section 414(q)(1)(B) is the preceding plan year – usually referred to as the "look-back year".

Notice 97-45, however, also provides the plan sponsor with the option of using the **calendar year**, which begins within the preceding plan year, as the look-back year. But this can only be done for section 414(q)(1)(B) – that is, for determining if an employee has compensation in excess of $80,000 (and is in the top-paid group, if elected).

If the plan sponsor wants to take advantage of the calendar year election, it must be specified in the plan. The plan can not leave open the possibility that the calendar year may be substituted for the regular look-back year.

Reminder: The calendar year election does **not** apply to IRC section 414(q)(1)(A) – the determination of whether an employee is a 5% owner. This determination must be made based on the plan year and the preceding plan year.

Prior Year vs. Current Year Testing

Introduction-prior year and current year method another option for employer for ADP/ACP test

Another 401(k) area where changes under GUST have left more than one option available to plan sponsors is in ADP test – that is, the nondiscrimination test under IRC section 401(k)(3).

> This discussion also pertains to the ACP test under IRC section 401(m)(2), although for purposes of this chapter we will focus on 401(k). All parallel ACP/401(m) references will appear with the applicable 401(k) provision in [brackets.] Example: The 401(k) [401(m)] test is a nondiscrimination test.

The change was brought about by SBJPA for plan years beginning after 12/31/1996.

Prior year method

GUST amended 401(k) and (m) to allow an employer to test a plan under the ADP or ACP tests using

- **prior** year data for the **non-highly compensated employees** (NHCEs)
- **current** year data for the **highly compensated employees** HCEs,

unless the plan sponsor **elects** to use current year data for both NHCEs and HCEs(as was required prior to the law change).

For more information on the prior year method, please see the 401k audit techniques chapter, CPE 2003.

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Prior Year vs. Current Year Testing, Continued

Electing the prior or current year method in the plan

Since the code now provides for more than one way to perform the ADP and ACP tests, Notice 98-1 stated that the plan must specify whether it is using the prior year or current year testing method.

Of course, that doesn't mean the plan must use those terms; but the plan must state which period (prior or current year) the NHCE ADP [ACP] calculation is based. Remember, current year data is always used to determine the HCE ADP.

This is another case where an option permitted by the Code must be provided for in the plan and the plan cannot give the employer a choice of whether to use the prior year or current year method outside of the plan document. Remember, this is a similar issue as with the top paid election.

> Thus, plan language such as "The NHCE ADP [ACP] will be calculated by using data under the current plan year rather than the preceding plan year **if the employer so elects**" would not be acceptable language. The employer can make this choice, but must provide this choice in the plan document to satisfy the definitely determinable requirement. Any language that leaves open the possibility that the plan could use either method or switch back-and-forth from year to year is unacceptable.

QNECs and QMACs with prior year testing

Many plans still want to use the prior year testing method with QNECS and QMACS.

Section IV of Notice 98-1 provides in order to be taken into account in calculating the ADP [ACP] for NHCEs for the prior year a QNEC or QMAC must be contributed by the end of the testing year.

Under Notice 98-1, section II.C., the testing year is the plan year for which the ADP or ACP for HCEs is being tested.

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Prior Year vs. Current Year Testing, Continued

Employer cannot use QNECs or QMACs for prior year testing

When using prior year testing, an employer cannot use QNECs or QMACs to correct a failed ADP or ACP test because the employer won't know until **after** the testing year whether or not the ADP or ACP test is failed. Once an employer determines the ADP/ACP test has failed, the deadline for making corrective QNECs and QMACs would have passed.

Of course QNECs and QMACs made prior to the deadline can be counted.

Example

A plan uses the prior year testing method for the 1999 testing year. QMACs that are allocated to NHCEs' accounts as of the last day of the 1998 plan year may be taken into account in calculating the ADP only if those QMACs are actually contributed to the plan by the last day of the 1999 plan year.

The problem arises because with the 1999 testing year, the employer won't know whether the plan has failed the ADP test until sometime in 2000. The testing year ends in 1999, and the HCE ADP, which is still calculated in the current year, would be calculated sometime in January 2000.

> If the plan fails the ADP test at that point, the employer could not make QNECs since these contributions had to be made by the end of 1999.

Prior year testing and new Plans

If you are reviewing a **new** 401(k)[401(m)] plan that uses the prior year testing method in its ADP[ACP]test provision, the plan must specify how it is handling the first plan year.

It can either provide that :

1. For the first plan year, it will use current year data for the NHCEs (as well as the HCEs), or

2. For the first plan year, the prior year NHCE ADP is deemed to be 3%.

NOTE: Section 401(m)(3) provides that rules similar to the rules of 401(K)(3)(E) shall apply for purposes of the ACP test.

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Prior Year vs. Current Year Testing, Continued

Plans That Incorporate ADP Test by Reference

As a result of the fact that the code now allows for alternative methods of applying the tests, plans that incorporate the ADP[ACP] test by reference (to the Code) no longer are complete. They now must specify whether the prior year or current year testing method is being used.

Also, if it is the first plan year, the plan must specify which of the two alternatives for new plans (above) is being used.

Excess Contributions [Excess Aggregate Contributions]

Introduction-defining excess contributions and excess aggregate contributions

The next area where law changes have increased the potential for finding problems with plan provisions concerns the treatment of Excess Contributions [Excess Aggregate Contributions].

As with the earlier issues, this discussion also pertains both to the ADP test under IRC section 410(k) and the ACP test under IRC section 401(m).

- The excess amounts which cause a plan to fail the ADP test are referred to as Excess Contributions.
- The excess amounts which cause a plan to fail the the ACP test are referred to as Excess Aggregate Contributions.

First of all, what are Excess Contributions [Excess Aggregate Contributions]? This is the term that the code uses to refer to the **excess** of the sum of the elective IRC section 401(k) deferrals [IRC section 401(m) contributions] made on behalf of HCEs **over** the maximum amount of HCE deferrals [contributions] which would still satisfy the ADP [ACP] test.

> In other words, the Excess Contributions [Excess Aggregate Contributions] represent the portion of the HCE deferrals [contributions] **which cause the plan to fail the ADP [ACP] test (and which, if removed, would allow the test to be passed).**

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Excess Contributions [Excess Aggregate Contributions],
Continued

Determining the Amount of the Excess

The amount of the excess is determined using a leveling method based on the HCEs' ADRs (Actual Deferral Ratios) [ACR (Actual Contribution Ratios)]. This is referred to as the **Ratio Leveling Method**. The plan language describing this process can vary widely, but it must get across the following:

The amount of the Excess Contributions [Excess Aggregate Contributions] is determined using a leveling method based on the HCEs' ADRs [ACRs]. This method begins with the HCE with the highest percentage and continues in descending order (of ADR [ACR] percentages) until the target HCE ADP [ACP] is reached (the target being the level at which the test will pass).

Determining the amount of distribution-dollar leveling method

Prior to SPJPA, the amount of Excess Contributions [Excess Aggregate Contributions] attributable to each HCE was distributed to that HCE (or recharacterized as employee contributions for that HCE, if the plan already contains provisions for employee contributions). Excess amounts are only hypothetically removed from the contributions for the HCEs with the highest ADRs [ACRs] (using ratio leveling) to determine the total amount to be distributed.

The amount of excess contributions continues to be **determined** under the ratio leveling method (based on the HCEs with the highest ADRs [ACRs]). Dollar amounts are not considered at this point in the process. However, Effective for plan years beginning after 12/31/1996, the excess amounts are now **distributed** to the HCEs with the highest **dollar amount** of contributions included in the ADP [ACP] test..

> Thus, once the amount of the excess contributions [excess aggregate contributions] is *determined* the amounts are then *distributed* using the dollar leveling method set forth in section 401(k)(8)(C) [401(m)(6)(C)] and Notice 97-2.

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Excess Contributions [Excess Aggregate Contributions],
Continued

Dollar leveling method

Under the dollar leveling method,the total amount is distributed to HCEs in the order of the dollar amount of IRC section 401(k) [IRC section 401(m)] contributions for each HCE, starting with the HCE with the highest amount. This process is continued until the total amount of excess contributions [excess aggregate contributions] have been distributed. But, if this process is properly followed, the ADP [ACP] test is deemed passed regardless of whether the ADP [ACP] test if recalculated would satisfy the ADP[ACP] test.

Here again the plan language can often be confusing or lacking. It is important to read the whole provision on determining and distributing (or recharacterizing) Excess Contributions [Excess Aggregate Contributions] and make sure it includes the two-step process as required by the law.

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Excess Contributions [Excess Aggregate Contributions],
Continued

Example-determining excess contributions-facts

There are three HCEs in a section 401(k) plan:

- HCE 1 has compensation of $80,000 and elective contributions of $8,800 for an ADR of 11%;
- HCE 2 has compensation of $100,000 and elective contributions of $9,000 for an ADR of 9%; and
- HCE 3 has compensation of $150,000 and elective contributions of $10,500 for an ADR of 7%.

The HCE ADP is 9%.

Determining the amount of excess contributions

Assume the HCE ADP needs to be 8% to pass the ADP test. The amount of excess contributions is determined by multiplying one or more HCE's compensation by the percentage that such HCE's ADR would have to be reduced in order to produce a HCE ADP of 8%. The percentage leveling method is used to reduce the HCE percentages.

Start with the highest ADR, which is HCE 1's 11%. This percentage is reduced to the next highest, HCE 2's 9%, and then both HCE 1 and HCE 2's reduced ADRs are further reduced to 8.5%, so that the HCE ADP using these reduced ADRs is 8%.

- HCE 1's ADR reduction by 2.5% produces excess contributions of $2,000 (2.5% x $80,000) and
- HCE 2's ADR reduction by 0.5% produces excess contributions of $500 (0.5% x $100,000) .

The total amount of excess contributions is $2,500.

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Excess Contributions [Excess Aggregate Contributions],
Continued

Distribution of excess contributions using percentage.

If used the percentage method for distributing the excess, $2,000 (adjusted for earnings) would be distributed to HCE1 and $500 (adjusted for earnings) to HCE2 if distributing based on the HCEs who had the excesses.

Note that HCE 1 had the highest excess, and that by distributing the $2,000, HCE's ADR would be reduced from 11% to 8.5%.

HCE 2 would receive a distribution of $500, and the ADR would be reduced from 9% to 8.5%.

With the HCE 1 and 2 ADR of 8.5%, the HCE ADP would be 8%.

Example illustrating dollar method

Using the above facts and the dollar method, the $2,500 of excess contributions would be allocated:

- $1,900 to HCE 3 (the HCE with the largest amount of elective contributions),
- $400 to HCE 2 (the HCE with the next largest amount of elective contributions) and
- $200 to HCE 1.

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Excess Contributions [Excess Aggregate Contributions],
Continued

Explaining the dollar leveling method

Note, the "dollar leveling method", HCE 3 gets back $1,500, reducing HCE 3's elective contribution from $10,500 to $9,000.

The next reduction is both HCE 2 and HCE 3, from $9,000 to $8,800, which is another $400. So far, $1,900 has been distributed ($1,500 and then $400).

For the remaining $600, each HCE receives $200. Thus, as totals:

- HCE 3 receives $1,900 ($1,500+$200+$200)
- HCE 2 receives $400 ($200+$200) and
- HCE 3 receives $200.

Note that if these distributions are made, the section 401(k) plan is treated as meeting the ADP test even though the HCE ADP, if recalculated after distributions, would not satisfy the ADP test.

As explained above, the ADP test would be satisfied by distributing the excess contribution to the participants with the highest ADR percentage—using the leveling method. If the distributions are not made to those employees, the actual ADRs will be different, resulting in a different HCE ADP.

Top-heavy Minimum Contributions and 401(k) Plans

Introduction

Although not a result of recent law changes, problems still occur in terms of how 401(k) plans are providing for the minimum contribution requirements of IRC section 416(c).

Key points for top heavy and 401k plans

The key points are:

- Elective deferrals on behalf of Key Employees **must be counted** in determining the highest Key Employee rate. (Non-Key Employees in a top-heavy plan must receive a minimum allocation of the lesser of (a) 3% of compensation, or (b) the highest Key Employee rate.)

- Elective deferrals on behalf of Non-Key Employees **can not be counted** in determining whether the minimum contribution requirement of IRC section 416(c) is satisfied.

- For plan years beginning prior to 1/1/2002, employer matching contributions that are used in either the ADP or ACP test **can not be counted** in determining whether the top-heavy minimum contribution requirement is satisfied.

  (Note: EGTRRA changed this for plan years beginning after 12/31/2001 to allow any employer matching contributions to count toward the minimum contribution requirement.)

Make sure the plan language ensures follows the top heavy rules for 401k plans

The effect of the above rules is that a 401(k) plan generally must provide a non-elective employer contribution (or a matching contribution for years after 12/31/2001) for each non-key employee equal to the top-heavy minimum contribution.

While the plan provision doesn't have to explicitly state that, the language must accomplish this effect. Sometimes, the plan language may fall short of this standard.

Bottom line: In reviewing 401(k) plans, be careful to read the top-heavy minimum contribution provision in the context of the plan's terminology with respect to its various types of contributions.

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Top-heavy Minimum Contributions and 401(k) Plans, Continued

Example of language which is unclear as to counting elective deferrals as HCEs

Example: The plan refers to its 401(k) elective contributions as employee contributions. If it uses the term employer contributions in the provision discussing the highest key-employee rate (for purposes of determining what the minimum contribution rate will be), it leaves the impression that the 401(k) elective contributions are not counted in determining that highest key employee rate.

Example, Language which is unclear as to what is counted

There are other times when the plan's top-heavy minimum contribution provision can leave the impression that the 401(k) elective contributions count toward both determining the highest key employee rate **and** meeting the top-heavy minimum contribution requirement for non-key employees.

SIMPLE 401(k) REQUIREMENTS

Introduction-distinction between Simple 401k, Simple IRAs and SARSEPs

The Small Business Job Protection Act of 1996 (SBJPA), P.L. 104-188, added new Internal Revenue Code sections 401(k)(11) and 401(m)(10), effective for tax years beginning after December 31, 1996.

SIMPLE 401(k) plans are qualified plans under Internal Revenue Code section 401(a), whereas SIMPLE IRA plans are not qualified plans under Internal Revenue Code section 401(a). Given this, the following discussion relates only to SIMPLE 401(k) plans and not to SIMPLE IRA plans.

The SIMPLE 401(k) is basically a replacement for SARSEPs (salary reduction simplified employee pensions), although SARSEPs that were established by December 31, 1996 may continue to operate after 1996.

If an employer's SIMPLE 401(k) meets various requirements (as noted at 1. through 6. below), the ADP and, if there are matching contributions, ACP tests are considered to be satisfied (therefore the multiple use test, in effect for years prior to 2002, also would not apply). Also, top-heavy requirements do not apply to a SIMPLE 401(k) plan. Other qualified plan requirements apply.

SIMPLE 401k plan—eligible employer

Eligible employer

An eligible employer is one that had no more than100 employees who received at least $5,000 of compensation from the employer for the preceding (CALENDAR) year. IRC sections 401(k)(11)(D)(i) & 408(p)(2)(C)(i).

Eligible employer who then fails to be an eligible employer-2 year grace period

An eligible employer who

- establishes and maintains a SIMPLE 401(k) plan for 1 or more years and
- then fails to be an eligible employer for any subsequent year

is considered to be an eligible employer for the 2 years following the last year the employer met the eligible employer requirement. IRC section 408(p)(2)(C)(i)(II)

2 year grace period does not apply to acquisitions

The 2-year grace period (noted at I.) does not apply where the 100-employee limit is not met because of acquisition of a related group member or acquisition of employees as part of a merger or sale of assets or similar transaction, unless the provisions of IRC section 410(b)(6)(C)(i) are met. Rev. Proc. 97-9 Appendix Section 1.2(a)

SIMPLE 401k plan—exclusive plan requirement and plan year

Exclusive plan requirement

The exclusive plan requirement is met for a year in which no contributions were made, or benefits accrued, for services during the year under any qualified plan of the employer, on behalf of any employee eligible to participate in the SIMPLE 401(k), other than contributions under the SIMPLE 401(k). IRC sections 401(k)(11)(A)(ii) & 401(k)(11)(C).

Plan year

The plan year must be the calendar year. An employer maintaining a 401(k) plan on a fiscal year basis must convert the plan to a calendar year in order to adopt the 401(k) simple provisions. Rev. Proc. 97-9, Section 2.04

SIMPLE 401k plan-election and notice

Election and notice-in general

The SIMPLE 401(k) plan must provide the employees at least a 60-day election period (November 2nd to December 31st of the prior year) during which they may make or modify a salary reduction election for the coming plan year. IRC section 401(k)(11)(B)(iii)(II) Rev. Proc. 97-9, Appendix Section 4.1(a).

Election and notice when an employee first become eligible

For the year an employee becomes eligible under the SIMPLE 401(k), the 60-day period may be any such 60-day period that includes either the date the employee becomes eligible, or the day before. IRC section 401(k)(11)(B)(iii)(II) Rev. Proc. 97-9, Appendix Section 4.1(b)

Notice will indicate whether 2% nonelective or 3% matching

The employer will notify each employee, prior to the 60-day period noted above, that he or she can make a salary reduction election or modify a prior election.

The notice will also indicate whether the employer is providing a 3% matching contribution or a 2% nonelective contribution (the plan must provide one or the other, but not both-see 5. Below). IRC section 401(k)(11)(B)(ii) Rev. Proc. 97-9, Appendix Section 4.2

SIMPLE 401k plan, contributions

Elective deferral limit

Elective deferral limit-each employee must be allowed to defer up to (but not more than) the elective deferral limit each calendar year. IRC section 401(k)(11)(B)(i)(I).

Elective deferral limits are as follows: (IRC section 414(v) Proposed Treas. Reg.1.414(v)-1)

Year	*Deferral limit*
1997-2000	$6,000
2001	$6,500
2002	$7,000
2003	$8,000
2004	$9,000
2005	$10,000

Catch-up contributions

Catch-up contribution deferral limit-a plan may provide for catch-up contributions for calendar years beginning on or after January 01, 2002. IRC section 401(k)(11)(B).

Only those employees who are at least age 50 by the end of the calendar year for which the catch-up contributions are made may make catch-up contributions during that calendar year. Catch-up contribution deferral limits are as follows: (IRC section 401(k)(11)(B)). Also, see Rev. Proc. 97-9, Appendix Section 3.2(a), 3.2(b) and 3.3.

Year	*Catch up Deferral limit*
2002	$500
2003	$1,000
2004	$1,500
2005	$2,000
2006	$2,500

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SIMPLE 401k plan, contributions, Continued

Employer contributions-matching or nonelective

The employer is required to make either

- matching or
- nonelective contributions

for each eligible employee for the year.

For any particular year, the employer may choose either option but may not choose both options for the same year.

Matching contributions

Matching contributions-if the employer chooses to make matching contributions, the amount of the matching contribution to be made for each eligible employee is the lesser of

- 3% of compensation, or
- the amount of the employee elective deferrals for the year.

Nonelective contributions

Nonelective contributions-if the chooses to make nonelective contributions, the amount of the nonelective contribution to be made for each employee that received at least $5,000 of compensation for the year is 2% of the employee's compensation for the year.

No other contributions can be made

Except for rollover contributions, no other contribution (than those noted above may be made.

SIMPLE 401k Plan-Compensation

Compensation definition

Compensation is total wages subject to federal income tax withholding (as described in IRC section 6051(a)(3), plus the elective deferrals made.

For self-employed individuals, compensation is net earnings from self-employment prior to deducting contributions under the plan for the self-employed individual. Rev. Proc. 97-9, Appendix Section 2.1.

Section 401(a)(17) applies

The compensation limit of IRC section 401(a)(17) applies.

SIMPLE 401k plan—other qualification requirements

Vesting

All amounts in the plan are nonforfeitable at all times. IRC section 401(k)(11)(A)(iii), IRC section 408(p)(3), Rev. Proc. 97-9, Appendix Section V.

Withdrawal restrictions, but hardship distributions may be available

The SIMPLE 401(k) contributions (5. above) are subject to the 401(k) distribution restrictions. These contributions (and the earnings thereon) can't be distributable before the earlier of:

- severance from employment,
- death,
- disability,
- plan termination (pursuant to IRC section 401(k)(10)), or
- age 59 ½ (for a profit sharing or stock bonus plan).

IRC section 401(k)(2)(B), Rev. Proc. 97-9, Section 2.06

The SIMPLE 401(k) contributions may be available for hardship withdrawal, if the plan so provides. Rev. Proc. 97-9, Section 2.06

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SIMPLE 401k plan—other qualification requirements, Continued

Plan amendments	A model amendment is provided to assist employers in adopting a plan that contains SIMPLE 401(k) provisions. Rev. Proc. 97-9, Appendix An employer adopting a new 401(k) plan containing the model amendment may make the SIMPLE 401(k) effective as of any date from January 1st to October 1st of the year in which adopted. For an employer with an existing 401(k) plan adopting the model amendment, the model amendment must be effective as of the following January 1st. Rev. Proc. 97-9, Section 2.08
Eligibility	Same as a regular 401(k) (no restriction noted for this in IRC section 401(k)(11)(A)). A SIMPLE 401(k) can't require an employee to be employed on the last day of a plan year or complete a minimum number of hours to receive a matching or nonelective contribution. IRC section 410(a). (IRC section 408(p)(4) is not applicable for this purpose)
Coverage	Same as a regular 401(k) (no restriction noted for this in IRC section 401(k)(11)(A)). IRC section 410(b).
Top heavy minimum	A SIMPLE 401(k) plan which meets the requirements noted above for any year shall not be treated as being a top-heavy plan for such year. IRC section 401(k)(11)(D)(ii)
Limits on elective deferrals—402(g) limits	The employee calendar year section 402(g) limit applies, as under a regular 401(k) plan. Rev. Proc. 97-9, Section 2.06.
IRC 415 limits	The employee 415(c) annual addition limit (limitation year is the calendar year, unless another consecutive 12 month period is elected) applies, as with any other qualified plan. Rev. Proc. 97-9, Section 2.06